1991

# Proposed statement of position : accounting for foreign property and liability reinsurance;Accounting for foreign property and liability reinsurance; Exposure draft (American Institute of Certified Public Accountants), 1991, Aug. 22

American Institute of Certified Public Accountants. Reinsurance Auditing and Accounting Task Force

# EXPOSURE DRAFT

# PROPOSED STATEMENT OF POSITION

## ACCOUNTING FOR FOREIGN PROPERTY AND LIABILITY REINSURANCE

**(Amendment to AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*)**

## AUGUST 22, 1991

Prepared by the
Reinsurance Auditing and Accounting Task Force of the Insurance Companies Committee
Accounting Standards Division
American Institute of Certified Public Accountants

Comments should be received by October 31, 1991, and addressed to
Ellise G. Konigsberg, Technical Manager, Accounting Standards Division, File 3164.FR
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036-8775

## SUMMARY

This proposed statement of position (SOP) provides guidance on how U.S. companies should account for property and liability reinsurance assumed from foreign insurance companies (foreign reinsurance). The periodic method should be used to account for foreign reinsurance premiums except when, because of local revenue recognition policies, the foreign ceding company cannot provide the information required by the assuming company to estimate both the ultimate premiums and the appropriate periods of recognition in accordance with U.S. generally accepted accounting principles. In such circumstances, the open year method should be used.

The periodic and open year methods are not interchangeable in the same circumstances.

The zero balance method should not be used.

The provisions of this proposed Statement would be effective for contracts entered into in fiscal years beginning on or after December 15, 199X.

This exposure draft has been sent to—

- State society and chapter presidents, directors, and committee chairpersons.
- Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.
- Organizations, firms, and individuals that the Reinsurance Auditing and Accounting Task Force has identified as having an interest in accounting for foreign property and liability reinsurance.
- Persons who have requested copies.

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August 22, 1991

Attached is an exposure draft of an AICPA proposed statement of position, Accounting for Foreign Property and Liability Reinsurance. The proposed statement of position has been developed by the Reinsurance Auditing and Accounting Task Force of the AICPA Insurance Companies Committee.

Comments on this exposure draft should be sent to Ellise G. Konigsberg, Technical Manager, Accounting Standards Division, File 3164.FR, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by October 31, 1991.

Written comments on the exposure draft will be available for public inspection at the offices of the American Institute of Certified Public Accountants after November 30, 1991, for one year.

Yours truly,

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The task force gratefully acknowledges the contributions of the late John E. Hart, formerly the task force chairman.

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## ACCOUNTING FOR FOREIGN PROPERTY AND LIABILITY REINSURANCE

### INTRODUCTION

1. The promulgation of rules and regulations by state insurance departments and the adoption of specialized insurance industry accounting standards by the Financial Accounting Standards Board (FASB) have resulted in considerable uniformity in accounting practices in the insurance industry in the United States. Outside the United States, insurance accounting and reporting practices vary widely. The diversity in insurance accounting and reporting practices of foreign insurance companies has led to questions on how U.S. insurance companies should account for property and liability reinsurance assumed from foreign companies (foreign reinsurance).

2. Reinsurers assuming business from domestic companies have historically had sufficient information to monitor and account for contract results. In contrast, some reinsurers assuming business from foreign companies do not receive such information, because in some foreign jurisdictions, insurance companies' accounting and reporting practices concerning periodic recognition of revenue and incurred claims are substantially different from U.S. practices. Therefore, reinsurers assuming business from foreign ceding companies cannot always obtain sufficient information to periodically estimate earned premiums for the business assumed from the foreign ceding companies.

3. A significant amount of reinsurance is transacted through syndicates organized by Lloyd's of London. Lloyd's syndicates report the amounts of premiums, claims, and expenses recorded in an underwriting account for a particular year to the assuming companies that participate in the syndicates. The syndicates generally keep accounts open for three years. Traditionally, three years have been necessary to report substantially all premiums associated with an underwriting year and to report most related claims, although claims may remain unsettled after the account is closed. A Lloyd's syndicate typically closes an underwriting account by reinsuring outstanding claims on that account with a syndicate for the next underwriting year. The ceding syndicate pays the assuming syndicate an amount based on the unearned premiums and outstanding claims in the underwriting account at the date of the assumption and distributes the remaining balance to its participants.

### CURRENT PRACTICES

4. Three methods are currently used in the United States to account for foreign property and liability reinsurance: the periodic method, the zero balance method, and the open year method.

#### Periodic Method

5. The periodic method of accounting for reinsurance provides for current recognition of profits and losses. It is used when ultimate premiums and the period of recognition can be reasonably estimated currently. Premiums are recognized as revenue over the policy term, and claims, including an estimate of claims incurred but not reported, are recognized as they occur. The periodic method is consistent with current practice for primary insurance and domestic reinsurance for which sufficient information is available to reasonably estimate and recognize earned premiums and related claims. (Refer to FASB Statement of Financial Accounting Standards No. 60, Accounting and Reporting by Insurance Enterprises.)

6. Some foreign ceding companies maintain the information necessary to estimate earned premiums, incurred claims, and related expenses currently. As a result, U.S. reinsurers doing business with these foreign ceding companies are able to account for reinsurance assumed by applying the same periodic method of accounting that they use to account for domestic reinsurance. Although not all foreign ceding companies maintain and report current information necessary to estimate earned premiums, incurred claims, and related expenses, some U.S. reinsurers have sufficient experience with the foreign business assumed to estimate earned premiums. When earned premiums can be estimated, sufficient information usually exists to estimate incurred claims and related expenses. Anticipated results based on either the reinsurer's experience or reported data make it possible to reasonably estimate underwriting results and use the periodic method.

Zero Balance Method

7. Many foreign ceding companies do not maintain the information necessary to estimate earned premiums. As a result, U.S. reinsurers doing business with these foreign companies generally are not able to apply the periodic method of accounting. Some of these companies use the zero balance method, which is a modified cash basis of accounting. This method is similar to the cost recovery method described in FASB Statement No. 60, paragraph 14. Because of the inherent lag in reporting claims, profits reported by foreign ceding companies in early years under this method often exceed the total profits that will ultimately be realized. To avoid reporting overstated profits, companies using this method adjust the records with arbitrary provisions for claims incurred in amounts that exactly offset the cash basis profits.

Open Year Method

8. Under the open year method, underwriting results of foreign reinsurance are not included in the income statement until sufficient information becomes available to provide reasonable estimates of earned premiums. The open year method is similar to the deposit method as defined in FASB Statement No. 60. Because the measurement period extends over more than one accounting period, premiums, claims, and expenses are not immediately included in operating results. Instead, they are accumulated and reported in the balance sheet as an open underwriting balance. The underwriting balance is disaggregated and reported in the income statement as premiums, claims, and expenses only when earned premiums become reasonably determinable. If it is probable that a loss has been incurred before an underwriting balance is closed, a provision for a loss generally is recorded. Examples of situations in which a provision may be recorded before an underwriting balance is closed include catastrophic losses, higher-than-expected claim frequency, significant unanticipated adverse events, or a negative open year account. The accounting treatment is similar to that for premium deficiencies described in FASB Statement No. 60, paragraph 32.

## COMPARISON WITH PRACTICES IN OTHER INDUSTRIES

9. Deferral of revenue occurs in industries that sell goods subject to rights of return. If a right of return exists, current recognition of a sale is not permitted unless the amount of future returns is reasonably estimable. If that amount is not reasonably estimable, recognition of income is postponed until the return privilege has substantially expired. Income recognition is also postponed for certain real estate sales through the use of the installment and cost recovery methods. Those methods are analogous to the open year method.

## DISCUSSION

10. Methods that defer recognition of underwriting profits raise financial accounting issues concerning (a) whether premiums and claims should be reported as income currently, even though the related underwriting balance[1] is deferred, and (b) whether the underwriting balance should be recorded as deferred income or as an addition to claim liabilities. Most companies that follow the zero balance method record premium and claim amounts currently and defer recognition of profits by additions to claim liabilities. Although this presentation provides timely information on the volume of business being conducted by the enterprise, the usefulness of the information is limited because the related profit margins are not also reported.

11. Current accounting literature supports alternative methods of financial presentation when profit recognition is deferred. For example, recognition as income of both revenues and related costs is deferred under the completed contract method until the contract is substantially completed. However, if either the installment method or cost recovery method is used to defer the recognition of gain on the sale of real estate, the sale and related costs are ordinarily reported on the date of the transaction. The deferred profit is reported separately in the income statement as a deduction from sales in the year the transaction occurs and as a separate item of revenue in future years' income statements, when the profit is recognized.

12. Proponents of presenting premiums, claims, and expenses in the income statement when the amounts are reported to the reinsurer point out that excluding those amounts from the income statement until an underwriting year is closed does not reflect the economic substance of current period activities under the reinsurance contract. In response to criticism that presentation of the amounts in the income statement may cause profit margins to be misstated, they argue that disclosure of profits deferred and profits recognized provides sufficient information for users to evaluate operating results.

13. Proponents of reporting deferred amounts in the balance sheet until the profits relating to the underwriting year are recognized point out that the income statement should reflect profit margins associated with the premium volume reported in the income statement, and that this can best be done by recognizing the related premiums in the periods the profits are recognized. They acknowledge that premiums, claims, and expenses associated with a contract in a period may be important information to users, but they argue that the information could be disclosed in the notes to the financial statements or in the statement of cash flows to avoid misstating the profit margins.

## CONCLUSIONS

14. The periodic method should be used to account for foreign reinsurance except in the circumstance described in paragraph 15.

15. If, due to local revenue recognition policies, the foreign ceding company cannot provide the information required by the assuming company to estimate both the ultimate premiums and the appropriate periods of recognition in accordance with U.S. generally accepted accounting

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[1] The term underwriting balance refers to the excess of reported premiums over reported claims and expenses. This amount is not intended to represent income realized on a contract.

principles, then the open year method should be used.[2] The presence of uncertainties that may be inherent in estimating earned premiums is not an acceptable basis for using the open year method. As discussed in paragraph 8, premiums, claims, commissions, and related direct taxes should not be reported currently as income under the open year method; instead, they should be included in the open underwriting balance to which they pertain. The underwriting balances should be aggregated and included in the balance sheet as a liability. Each underwriting balance should be kept open until sufficient information becomes available to record a reasonable estimate of earned premiums. The underwriting balance should be disaggregated and reported in the income statement as premiums, claims, commissions, and related direct taxes when earned premiums are reasonably determinable.

16. If it becomes probable that a loss has been incurred before an underwriting balance is closed, a provision for the loss should be recorded.

17. The periodic and open year methods are not interchangeable in the same circumstances. The periodic method should be used to account for foreign reinsurance. Only if reasonable estimates cannot be made currently, for the reason discussed in paragraph 15, should the open year method be used. The periodic and open year methods are not alternative accounting principles as discussed in Accounting Principles Board (APB) Opinion No. 20, Accounting Changes. Rather, one or the other is to be used depending on the circumstances. As such, changes between these methods are not accounting changes.

18. The zero balance method should not be used, because it results in misstatement of the income statement by arbitrarily recognizing revenues and costs. The method also causes the profit to be reported in periods other than those in which the related premiums, claims, and expenses are reported.

## DISCLOSURES

19. Disclosure in the financial statements of an insurance company's accounting policies should include a description of the methods used to account for foreign reinsurance. In addition, for foreign reinsurance accounted for by the open year method, the following should be disclosed for each period for which an income statement is presented:

- The amounts of premiums, claims, and expenses recognized as income on closing underwriting balances

- The additions to underwriting balances for the year for reported premiums, claims, and expenses

Also, the amounts of premiums, claims, and expenses in the underwriting account should be disclosed for each balance sheet presented.

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[2] If the foreign ceding company maintains supplementary records that are sufficient to reasonably estimate earned premiums currently, then the U.S. assuming company should obtain the necessary information and use the periodic method to account for the foreign reinsurance.

## EFFECTIVE DATE AND TRANSITION

20. This SOP should be applied prospectively to contracts or arrangements covered by it and entered into in fiscal years beginning on or after December 15, 199X. Retroactive application, by restating all prior years presented, is encouraged but not required.